Successful property development

Psychology, Success

Throughout this paper the masculine gender is used when referring to developers. This is purely for convenience and does not imply that successful developers have to be male. Demand for new buildings from tenants and owner occupiers is the basis of all commercial property development in the United Kingdom. A typical development scheme will be initiated by a developer identifying a demand for a new building or buildings in a certain location. A major office user for example may wish to combine a number of regional offices into one new building able to accommodate new echnology and enable all of the Company's departments to be housed under one roof. The image to be presented by the new building will also be important and the Company may prefer a prominent town centre location with easy rail access or a fringe of town location on the motorway network.

The experienced developer will know that if a development is to be successful the location must be the one which will appeal to tenants or purchasers who will either pay rent or a capital sum to occupy the property. There are many examples of unsuccessful schemes which failed because of poor location. With shopping centre evelopment the choice can be very subtle and a slightly 'off-pitch' location may be enough to discourage tenants from leasing shop units in the new centre. If a site for a new development is identified and the site (or redundant buildings) is available for purchase, planning consent for the scheme must be sought from the Local Authority. It is usually the case that the developer will have concentrated on those locations where the planners will support development proposals and planning consent is likely to be received. If the location is correct and planning consent is likely the developer must also rrangefinanceto buy the site, build the scheme and let (or sell) it.

He may also wish to sell the completed income producing investment. If he does so and themoneyhe receives from the sale of the investment is more than the capital and interest he borrowed to build the scheme, he will receive a monetary profit. There are many sources of finance for developers but conventionally money will be borrowed from banks to buy the site and build a scheme with long term finance being provided by life assurance funds and pension funds. Long term finance in this ontext means the purchase of the completed investment by the fund which will enable the developer to repay all his short term debt and (hopefully) give him a profit. The investment market and development market are therefore closely linked and the developer will be mindful of the fund's requirements from the start of the development process. The most common form of development funding which involves the institutions if known as 'profit erosion, priority yield'.

This method allows the developer to borrow most of his short term finance from the institution and not pay it back until the cheme is completed and let. At this time the fund takes over the scheme in return for providing the developer's short term monies. The developer departs with a lump sum fee for carrying out the project which will be calculated by capitalising that amount of rent from the scheme which will be calculated by capitalising that amount of rent from the scheme which exceeds the fund's required return on the money lent; in other words its 'priority yield'. Even if the rent from the scheme does not exceed the fund's priority yield, the developer will still receive a fee but obviously not as uch as he would get if he lets the building(s) at a high rent. There are many other types of development funding some of which are described in 'Property and Money' by Michael Brett (see the bibliography at the back of this booklet).

The developer will employ a professional team to design and cost the proposed building. The architect as leader of the design team has a crucial role to interpret his client's intentions and produce a design which will meet the requirements of tenants, planners and long term funders. Other commentators such as journalists, he general public, and the Prince of Wales may also criticise the design of a scheme where it is perceived to be ugly or inappropriate for its location. Successful commercial development requires therefore a combination of good location, planning consent, good design and funding. Even if these factors are present the scheme may still fail, at least in the short term, if the economy is weak and firms cannot expand. This introduction provides a resume of a typical development and the process can now be considered in more detail. The Developer The developer is the instigator of the scheme.

He provides the entrepreneurial flair to identify the development opportunity and bring it to a successful conclusion. In doing so he will make use of established relationships with commercial estate agents and his knowledge of the occupier market. Most large development companies specialise in particular areas of the market. Slough Estates for example, built its reputation in the development of industrial and warehouse property whereas

Hammersons developed the firstshopping mallin the United Kingdom at Brent Cross. Some life assurance funds act as their own developer and one example is Norwich

Union in the development of the Bentalls centre in Kingston on Thames. Various government agencies also act as developers such as District and RegionalHealthAuthorities with hospital building. Increasingly, the newly privatised utilities will carry out their own developments. There are many types of developers. Some are 'developer traders' who build with a view to selling the scheme when it is complete. Others will develop and hold the completed investment in their investment portfolio. Some developers are quoted on the stock exchange and others are little more than one man bands.

Throughout the development process, but crucially at the start before funds are committed, the commercial developer will carry out an appraisal which will predict the eventual profits to be earned from the scheme. A considerable amount of work has to be done to produce a full appraisal as all the costs of the scheme have to be considered. The site itself will have to be fully investigated and this will involve bore hole surveys to enable the structural engineer to estimate the cost of the foundations. An environmental impact study may be required before planning consent is forthcoming.

With the assistance of his agent, the developer will also predict the rent which the scheme will produce and (if the investment is to be sold), the investment value. If a scheme is to be successful the investment value less all capital and interest costs will have to leave an acceptable profit. If a developer has used rents in the appraisal which are too high, perhaps in expectation of rent rises in the development period, he may eventually make no profit at all and the scheme (from the developer's viewpoint) will have failed. To avoid risk and to attract other tenants to a development, a developer will often eek a pre-let tenant for a scheme. Before construction starts, a tenant will sign an agreement to lease all or part of the scheme at an agreed rent.

This is particularly valuable in shopping centre development where an anchor tenant such as a department store will make a commitment before development commenced, thereby giving confidence to other lessees to take shop units. A developer who borrows money to buy a site, construct a building, and seek lessees will have no appreciable earnings until the scheme is let. It would be difficult therefore, for any interest on capital borrowed to be repaid during the development period.

It is usually the case that interest is repaid as a lump sum when the fully let investment is eventually sold. Interest in these circumstances is said to be 'rolled up' until the end of the development period. In arranging finance, the developer will often have a short term interest in the scheme, whereas the fund purchasing the investment when fully let, has a long term interest. Funds are, therefore, particularly interested in tenant quality in the longer term and building flexibility which may not be of primary importance to the developer. Local Authorities may initiate development, particularly retail, by making town centre ites available on ground leases to developers. The

Authority will have a long term interest in the scheme's success, as they will receive a grounds rent, probably geared to the full rental value of the development. Not all developers have a short term interest in a development. Major developers may hold completed investments in a portfolio rather than arrange long term finance by selling the investment to a fund. Planning In the words of Clara Green 'planning applications (like prayers) receive one of three answers - yes, no or yes but. '

The process can be one of great frustration and ifficulty for developers and for a major scheme it is usual for a specialist planning consultant to be employed to negotiate a consent with the Local Authority. Planning law is complicated but in general terms, planning consent is required for most major building in the United Kingdom. The department of theEnvironmentis responsible for planning and the Secretary of State for the Environment is advised by teams of professional planners, surveyors and architects. All applications are made to local councils and it is only the most important or controversial applications which will be of interest to the higher tier of overnment. Most applications are, therefore, decided locally although the Secretary of State may decide to call in any application at his or her discretion. To obtain planning permission, an application will be made to the District Council although applications in the future also may be considered by the new unitary authorities. The developer can choose the type of application he wishes to make. If he wishes to seek approval to the principle of development, he can make an outline application.

This is sometimes referred to as a red line application, as a red ine is drawn around the site plan supporting the application. If consent is granted, this will be subject to reserved matters and the developer will have to seek a subsequent consent for these detailed matters later. Alternatively a full application may be made which will include all detailed matters as well as the basic principles. The Local Authority will decide the application in the context of plans which will have been previously published and approved by the Secretary of State. Under the present two tier system of Local Government, the County Councils produce structure lans for their area which show in strategic terms the type and location of development which will be permitted during the period of the plan.

The District Councils produce local plans which deal with detailed matters related to specific areas of land. If the planning application does not accord with the local plan, the Local Authority will be justified in refusing the application but obviously a developer would be unwise to make an application of this type. Structure plans have a life of between 5 and 15 years and comprise a lengthy written statement supported by explanatory diagrams.

The important matters dealt with in the structure plan are strategic matters such as tourism and leisure, waste disposal, new housing, employment and transport. The Authority has a two month period in which to decide an application but it can ask the applicant for more time. If the application is refused the applicant can appeal to the Secretary of state and the matter in the majority of cases, will be decided by a Government Inspector. In major cases, the Inspector will make recommendations to the Secretary of State who will, after advice, take a decision.

There may also be a Public Local Enquiry here evidence is heard by the Inspector over a number of days from all interested parties. In producing their structure and local plans as well as deciding applications, Councils have to take into account policy statement produced by the government. These are called Planning Policy Guidance Notes (PPGs) and they are published or amended from time to time. Two of the most important are PPG 6 which relates to out of town retail development and PPG 13 which deals with transport. There are a total of 25 PPGs and many are frequently revised. For example a new PPG 12 was produced in April 1999.

This revision emphasised the importance of regional planning which now has it own PPG (PPG 11) and also stressed the government's commitment to a plan led system. Any developer seeking to build against government guidance as stated in the PPGs faces a long, expensive and uncertain battle and therefore is well advised to tailor development proposals to accord with published guidance. The government is at pains to demonstrate that the plan led system is sensitive to demographic changes and this is seen in the revisions to PPG 3 (Housing) which take account of the prediction that '7 out of ten new ouseholds forming over the next 20 years are likely to be single person households' (Nick Raynsford, Housing and Planning Minister).

A topical revision PPG 25 (Flood Risk) which aims to avoid development in flood risk areas and emphasises a precautionary approach in marginal areas with flood defences to be shown to be in place (and paid for by the developer) before development is approved. The Development Team The team will be employed by the developer at the start of a project and it role will encompass design, costing, funding and marketing. In summary its functions are as follows:

Architect The Architect is the leader and coordinator of the design team who has a major role in interpreting his client's requirements and producing a design brief. The brief establishes the client's basic requirements and from this the Architect and other members of the design team will produce detailed design drawings. These will eventually be given to selected building contractors who will tender for the job of constructing the building. During construction, the Architect will inspect the work as it proceeds on behalf of his client. Because the Architect's work is so important he ill be paid a fee based on a percentage of the total cost of the building work. For a new building this will normally be between 4% and 5% of the cost of the work. Quantity Surveyor The Quantity Surveyor estimates the eventual cost of the new building and will produce regular cost checks as the design is developed.

Before tenders are invited from building contractors, he will inform the client of the estimated cost of the works (the pre-tender estimate) and the client can then proceed to tender with confidence. Services and Structural Engineers In some instances the engineers will be responsible for producing design drawings nd specifications of the building services (air-conditioning, electrical installation etc) and the structure (foundations, structural frame). Increasingly however, the services engineer will only produce a statement of how the services will perform (a performance specification) rather than a full design. In these circumstances, design becomes theresponsibilityof the contractor. Estate Agents Developers usually have established relationships with firms of estate agents who will be aware of development opportunities. The agent will also provide marketing advice and will be responsible for letting the building.

Other Consultants Other consultants include solicitors, landscape architects and planning consultants. With some complicated and large schemes, a project manager may oversee the project on behalf of the client. Specialist noise or environmental consultants may be required where development will take place in environmentally sensitive areas where special planning conditions have been imposed. Successful Schemes A scheme will be successful if its location and design has attracted a number of first class tenants and will continue to do so in the future should any tenants vacate. A uccessful scheme will provide a secure and growing investment for the eventual long term investor as well as an adequate monetary profit for the developer.

There are many reasons why development schemes are unsuccessful, some of which are discussed below: Poor Location This is the most obvious but nevertheless very common reason forfailure. A shopping scheme may be located where there is a lack of pedestrian flow. An office building may be located where vehicular access is difficult or the chosen site does not provide the required image and identity for the tenant/s. On a wider scale, he development may be located in a city which is in decline, to the detriment of long term investment quality. Some commentators are casting doubt on the future quality of fringe of town retail warehousing schemes which do not have the support of an established town centre. Poor Design A shopping centre must be designed to maximise pedestrian flow and enable shoppers to both park and gain easy access. If the design fails to do this, the public may avoid the centre and tenants will be hard to find.

Also shopping centres must allow frequent changes of image and must provide the correct ambience for the ublic. Attention to detail with the internal design will allow this to benefit the investment. Thee are many examples of office buildings constructed in the 1960's and 1970's which do not provide the necessary ducting and image for modern tenants using today'stechnology. These developments may have been regarded as successful when they were first constructed, but in terms of a long term investment are of dubious quality. Lack of flexibility with many buildings means that where occupier requirements change the buildings cannot and voids are the result. Increased Costs during Design or Construction

If a developer allows costs to increase, he will eventually make no profit whatsoever from the scheme. If costs increase beyond those used in the appraisal the developers profit will be eroded. The expertise of the design team to contain costs whilst, at the same time, producing a quality building is of vital importance but sometimes mistakes are made. A lack of coordination between building work and services is a typical example leading to redesign, delay and increased costs. Planning Errors When a contract is awarded to a contractor, it is important that the site of the evelopment is firstly in the legal control of the developer and secondly the same site for which planning consent has been granted. There have been many examples of mistakes in this area to the detriment of the project. Empty Property A newly built shopping centre with few tenants is clear evidence of a scheme which falls short of success. There are many examples amongst those centres completed during the recession. As with office and warehousing property pre-let tenants are particularly valuable in recessionary periods. Public Sector Development The Private Finance Initiative.

In the past public sector development such as roads, hospitals and bridges were built by government contracting with the private sector for the design and construction works. Civil servants and their consultants would work to precise specifications of what was required to be built. When the development was complete the government would then be responsible for running the completed hospital, road or whatever to the benefit of the public. The Private ~Finance Initiative (or PFI) is intended to revolutionise the traditional method of producingpublic facilitiesdescribed above.

It was conceived in 1992 during Norman Lamont's troubled chancellorship and was vigorously supported by his successor Kenneth Clarke. In essence PFI only required the government to state how the building is to be used and the performance it must achieve. The private sector is then invited to tender for the design, construction and running of the new facility. The reward for doing this is negotiated with the government agency responsible for the facility and will usually take the form of a regular monetary payment so long as the facilities provided continue to meet the agreed criteria.

Kenneth Clarke stated that PFI is 'a radical and far reaching change in capital investment in public services which will break down further barriers between the public and private sectors'. The central argument in favour of PFI is that the private sector is more capable of promoting efficiency than government and will provide business solutions to public sector requirements. It is also argued that the risks of increased construction and running costs, which appears to be a feature of public sector schemes, will disappear with PFI where all the risks are borne by the private sector.

Critics of PFI point out that it is extremely difficult to produce a performance specification for, say, a highly complex building such as a hospital and this will lead to private sector contractors being allowed to cut corners to the detriment of the public. It is also pointed out that the government can always borrow money more cheaply than the private sector and that this will inevitably lead to increased costs which will be passed on to the public. The change of government in May 1997 led to a thorough review of the experience gained from using PFI in the previous five years. Malcolm Bates was appointed to arry out a review which resulted in 29 recommendations aimed at rationalising and reinvigorating the PFI process.

The 'Treasury Taskforce' was the government's response to the review and this body consisted mainly of city financiers who were charged with building up PFI expertise in government. The taskforce had a life of three years and is replaced by 'Partnerships UK' which will operate as a joint private/public consultancy to assist with the PFI process. There are currently hundreds of

PFI schemes in the process of completion and the present government is wedded to this form of procurement for public sector projects.